

NO. 2001-4081-3

INDEPENDENT STATE AUDITOR'S
REPORT ON THE
CENTRAL ARTERY/THIRD HARBOR TUNNEL PROJECT'S
MANAGEMENT CONTROLS OVER CONTRACTUAL DOCUMENTATION
RELATING TO THE WRAP-UP INSURANCE PROGRAM
NOVEMBER 1, 1992 THROUGH SEPTEMBER 30, 2000

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The Central Artery/Third Tunnel Project (CA/T) is a 7.5-mile interstate highway project designed to significantly reduce traffic congestion in downtown Boston through the construction of an eight- to 10-lane underground Central Artery, a four-lane underwater tunnel that crosses Boston Harbor, and a commercial traffic bypass road through South Boston. CA/T construction began in 1991 and is well underway in certain areas, including the South Boston Bypass Road, the Boston Marine Industrial Park, the tunnel crossing under Boston Harbor, the Bird Island Flats area of Logan International Airport in East Boston, and the Central Artery.

Because of a surprise CA/T announcement on February 1, 2000 of a potential \$1.4 billion cost overrun, the U.S. Secretary of Transportation requested that the Federal Highway Administration (FHWA) establish a multi-disciplinary Federal Task Force to analyze the oversight process for CA/T, review the structure of the cognizant FHWA Division Office responsible for the oversight, and determine the effectiveness of the supporting document reporting systems. On April 11, 2000, the Task Force issued its report stating that FHWA must move beyond its failed “partnership” approach, which was betrayed by state actions. The Task Force made 34 recommendations to achieve independent and critical oversight of CA/T. It also estimated that a more realistic cost estimate for the project is now \$13.4 to \$13.6 billion. As a result of the Task Force report, the Governor of the Commonwealth replaced the Chairman of the Massachusetts Turnpike Authority, who had responsibility for project management. In June 2000, CA/T revised its cost estimate to \$13.5 billion. In its most recently released finance plan, dated October 1, 2000, CA/T officials estimated the total cost of the project to be \$14.1 billion. The revised estimate is a result of a recently completed comprehensive cost and schedule revision known as CSU 7.

Although design and construction contractors can purchase their own insurance coverage and recover costs through their contracts, large projects such as CA/T sometimes purchase “wrap-up” insurance that provides contractors working at such projects with coverage for a variety of risks. Included among the insurance coverage provided contractors under CA/T’s wrap-up program is workers’ compensation insurance, which covers all project workers for job-related injuries or diseases, and general liability insurance, which covers project workers and third parties for injuries and losses resulting from negligence or omissions. CA/T obtained workers’ compensation and general liability insurance coverage from the American International Group, Inc., (AIG) of New York City. Approximately \$503 million, or almost 87%, of the estimated CA/T wrap-up insurance program cost of approximately \$575 million, represents workers’ compensation and general liability insurance costs.

To date, our 13 interim reports, including three reports dealing exclusively with CA/T’s wrap-up insurance program, have identified approximately \$446 million in unnecessary, excessive, and avoidable costs as well as significant savings opportunities.

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INTRODUCTION

Background

Although design and construction contractors can purchase their own insurance coverage and recover costs through their contracts, the Central Artery/Third Harbor Tunnel Project (CA/T) purchased "wrap-up" insurance that provides contractors working at CA/T with coverage for a variety of risks. Included among the provided insurance coverage is workers' compensation insurance, which covers all project workers for job-related injuries or diseases, and general liability insurance, which covers project workers and third parties for injuries and losses resulting from negligence or omissions. CA/T obtained workers' compensation and general liability insurance coverage from the American International Group, Inc., (AIG) of New York City. Approximately \$503 million¹, or almost 87%, of the estimated CA/T wrap-up insurance program cost of approximately \$575 million, represents workers' compensation and general liability insurance costs.

Audit Scope, Objectives, and Methodology

This is our third interim report relating to specific aspects of CA/T's wrap-up insurance program. We reviewed the standard insurance policies between AIG and CA/T and the Large Deductible Agreement (LDA) that covered the workers' compensation insurance for the period November 1992 through October 1995. We also examined the one available general liability draft agreement covering the period November 1992 through October 31, 1995. We met with officials of CA/T, Bechtel/Parsons Brinckerhoff, and the Federal Highway Administration to discuss the workers' compensation and general liability insurance programs and related documentation.

The objective of our review, which covered the period November 1, 1992 to September 30, 2000, was to determine the effectiveness of selected management controls over the wrap-up insurance program. Our

¹ A portion of this amount is paid to the AIG as premium and for claims processing related expenses. The majority of the \$503 million is available to CA/T to pay claims that it is liable for.

examination was made in accordance with applicable generally accepted government auditing standards for performance audits.

AUDIT RESULTS

Inadequate Management Controls over the Timely Formalization of Contractual Documentation

During our examination of the Central Artery/Third Harbor Tunnel Project (CA/T) wrap-up insurance program, we found a situation that must be addressed immediately by CA/T management. Specifically, although standard annual policies guaranteeing insurance coverage have been executed, contractual agreements covering major provisions of the wrap-up insurance program's workers' compensation and general liability insurances had not been signed for lengthy periods of time or had never been signed at all, contrary to sound management practices.

Wrap-up insurance programs, also referred to as Owner Controlled Insurance Programs (OCIP), are created by contract between the insured and an insurance carrier. The contract (agreement) contains significant clauses that augment or supersede provisions of the annual standard insurance policy that provides insurance coverage. American International Group, Inc. (AIG) provides the workers' compensation and general liability insurances for the project and CA/T's June 16, 2000 Finance Plan Update estimates that the project's total cash requirement for insurance will amount to \$575 million, of which \$503 million, or 87%, represents workers' compensation and general liability insurance premium payments. Our audit revealed that, other than the standard annual policies guaranteeing insurance coverage, contractual agreements covering major provisions of the OCIP's workers' compensation and general liability insurances had not been signed for lengthy periods of time or had never been signed at all. In fact, the only signed agreement involving either insurance was one covering workers' compensation for the three-year period November 1992 through October 1995. Even in this instance, the agreement was not signed until four months after the expiration of the three-year period of insurance coverage, or more than three years after the effective date of insurance coverage.

According to CA/T officials, the workers' compensation insurance agreements in subsequent years and the general liability insurance agreements are "unsigned drafts." Clearly, operating a multimillion

dollar program without signed agreements is contradictory to sound business practices and is an example of inadequate internal controls.

Moreover, our examination of the one agreement that had been signed revealed that it contained various important provisions affecting both the cost and coverage afforded the CA/T under the workers' compensation insurance, including the following:

- The establishment of a Trust Fund and many pages of rules and procedures governing its operation.
- The maximum dollar amount of insurance claims that CA/T will be responsible for covering before AIG becomes liable for the balance.
- The allocation of CA/T premium payments to the various Trust Fund accounts and the basis for distributing millions of dollars in interest earned on those accounts between CA/T and AIG.

The schedule below presents the type of insurance, the period of coverage, premium amount, effective dates of coverage, and the elapsed time period through September 30, 2000 not covered by a signed agreement.

<u>Period of Coverage</u>	<u>Premium Amount (In Millions)</u>	<u>Effective Date of Coverage</u>	<u>Date Signed</u>	<u>Period Not Covered by a Formal Agreement Years/Months²</u>
Workers' Compensation				
11/92-10/95	\$ 73.8	Oct. 23, 1992	Feb. 23, 1996	3/4
11/95-10/98	95.2	Nov. 1, 1995	Not Signed	4/11
11/98-10/05	221.0	Nov. 1, 1998	Not Signed	1/11
<u>General Liability</u>				
11/92-10/96	62.2	Nov. 1, 1992	Not Signed	7/11
11/96-10/98	47.7	Nov. 1, 1996	Not Signed	3/11
11/98-10/05	<u>122.0</u>	Nov. 1, 1998	Not Signed	1/11
Total	<u>\$621.9*</u>			

² The calculation is as of September 30, 2000.

* As recommended by the State Auditor, CA/T has used or plans to use a substantial amount of trust funds to pay workers' compensation and general liability premiums. This accounts for the difference between the total premium of almost \$622 million and the previously mentioned \$503 million.

Chapter 259, Section 1, of the Massachusetts General Laws, in its aim to protect the rights of contracting parties, requires any agreement whose length of performance is to exceed one year to be in a signed, written document. Payments for goods and services without a signed contract or agreement is contrary to CA/T's established accounting policies.

We also found that CA/T obtained risk management advisory services without having a signed subcontract with the vendor. Willis Corroon Corporation, an international insurance broker and advisor, was hired by CA/T to review the February 2000 CA/T Risk Management Report. Willis Corroon reviewed and endorsed CA/T's risk management plan, which was included in the March 15, 2000 CA/T Finance Plan. A review of the procurement group's files relating to this particular subcontract shows that the project procurement officials, beginning in June 1999, sought to obtain information to formalize the subcontract. However, as of August 22, 2000, the subcontract had not been signed for this completed work. Officials from CA/T's procurement group stated that no payment would be made until a signed agreement has been received.

Recommendation: CA/T should operate its workers' compensation and general liability insurance programs under signed agreements that cover all aspects of these insurance programs. Accordingly, project officials should review and strengthen their management controls over the timely formalization of all CA/T contractual documentation.

Auditee's Response: The CA/T Project Director stated, in part:

I disagree ... that the CA/T Project was in any way exposed to material risk because the formal OCIP legal agreements were unsigned. Insurance coverage for the Project has been in place at all times with no gaps in coverage since the inception of this program ... In addition, the commercial terms of the coverage, which were amended in 1996 and 1998 to the benefit of the Project, were documented through the issuance of insurance binders. While the underlying legal agreements were not in place, these documents simply reflect the terms of the binders in greater detail. I do agree with the report's findings that the OCIP formal legal agreements should have been executed in a timely manner. The finalization of these documents was the subject of protracted and sometimes difficult negotiations with our insurance carrier. I do wish to report to you that the 1996 agreements have been executed and I anticipate that the 1998 documents will be completed within 60 days.

Insurance binders are the typical method used in the industry to provide the insured with temporary coverage, until the formal policy is issued. Although binders are usually evidenced by some form of written document, binders may be oral, and still be enforceable. The binder is effective from the time of its issuance, until issuance of the formal insurance policy.

We disagree with your assertion that MGL Chapter 259, Section 1 supports the conclusions reached in this Report. There are two potential exceptions to the application of the Statute. First, the agreements for the issuance of insurance policies could be characterized as successive annual contracts, and thus not within the application of the statute. On this point, the issue is whether the contract could be performed within a year, not whether it was ... Whether the other agreements “could” be performed within a year, in light of the termination provisions, is an arguable point.

Second, even if the statute applies, the agreement would be enforceable if there is “some memorandum or note thereof” in writing signed by the party to be charged. On this point the issue is whether the correspondence and documents which have been exchanged between the parties are sufficient, when read together, to constitute an enforceable contract....

As discussed above, the record that you have been supplied with is replete with writings evidencing the essential terms of the OCIP agreements. Simply put, the Project at all relevant times had in place (a) binding agreements with AIG on the commercial terms of the OCIP, and (b) insurance policies protecting the Project’s interests.

I wish to inform you that the Willis Corroon contract has been executed. Upon completion of the 1998 agreements we will forward them to your office.

Auditor’s Reply: We agree with the Director that CA/T had insurance coverage and noted this on page 3 of our report, where we stated, “standard annual policies guaranteeing insurance coverage have been executed....” However, the contractual agreements covering major provisions of the OCIP, as discussed on page 4 of our report, were unsigned throughout much of the period.

Although the Director acknowledges that the underlying legal agreements were not in place and also agreed that formal legal agreements should have been executed in a timely manner, he notes that the “legal agreements” merely reflect the already agreed upon provisions contained in the insurance binders. Although a binder was in effect for the general liability insurance for the period 1992 through 1995, CA/T officials told us that a binder was not prepared for the workers’ compensation insurance for that period. The workers’ compensation and general liability binder for the period 1995 through 1999 was dated 14 months after coverage started and not signed by CA/T officials and Sheppard, Riley, and Coughlin (SRC), the insurance agent/advisor to CA/T. Likewise, SRC and CA/T officials did not sign the most

recent binder covering the project through 2005 even though their signatures are required according to the terms of the binder. Moreover, the Director's statement that these agreements are the subject of protracted and sometimes difficult negotiations with the insurance carrier contradicts the statement that the agreements simply reflect the terms of the binders in greater detail. Logically, one would ask how a pre-existing binder could reflect the results of on-going "protracted and sometimes difficult" negotiations.

This report is critical of the project's internal controls relative to the contractual agreements covering major provisions of the OCIP program as opposed to the standard annual policies guaranteeing insurance coverage. Accordingly, our discussion of Chapter 259, Section 1, of the General Laws pertains only to the former contractual agreements. The Director advised us that it is arguable whether the provisions of this law apply to these contractual agreements. Until legal clarification is made certain, and in keeping with good internal controls, it is necessary that these agreements be formalized timely.

We are pleased that the general liability agreements covering the periods November 1992 through October 1996 and November 1996 through October 1998 have been finally signed and that the Willis Carroon contract was recently executed. Likewise, the Director reports that the agreement covering workers' compensation insurance for the period November 1995 through October 1998 has been signed. The Director also notes that agreements for general liability and workers' compensation insurances for the period November 1998 through project completion should be completed within 60 days. The project's current effort to formalize these agreements is a positive action that we will monitor in future reviews of CA/T.